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No. 292

In the Supreme Court of the United States

OCTOBER TERM, 1944

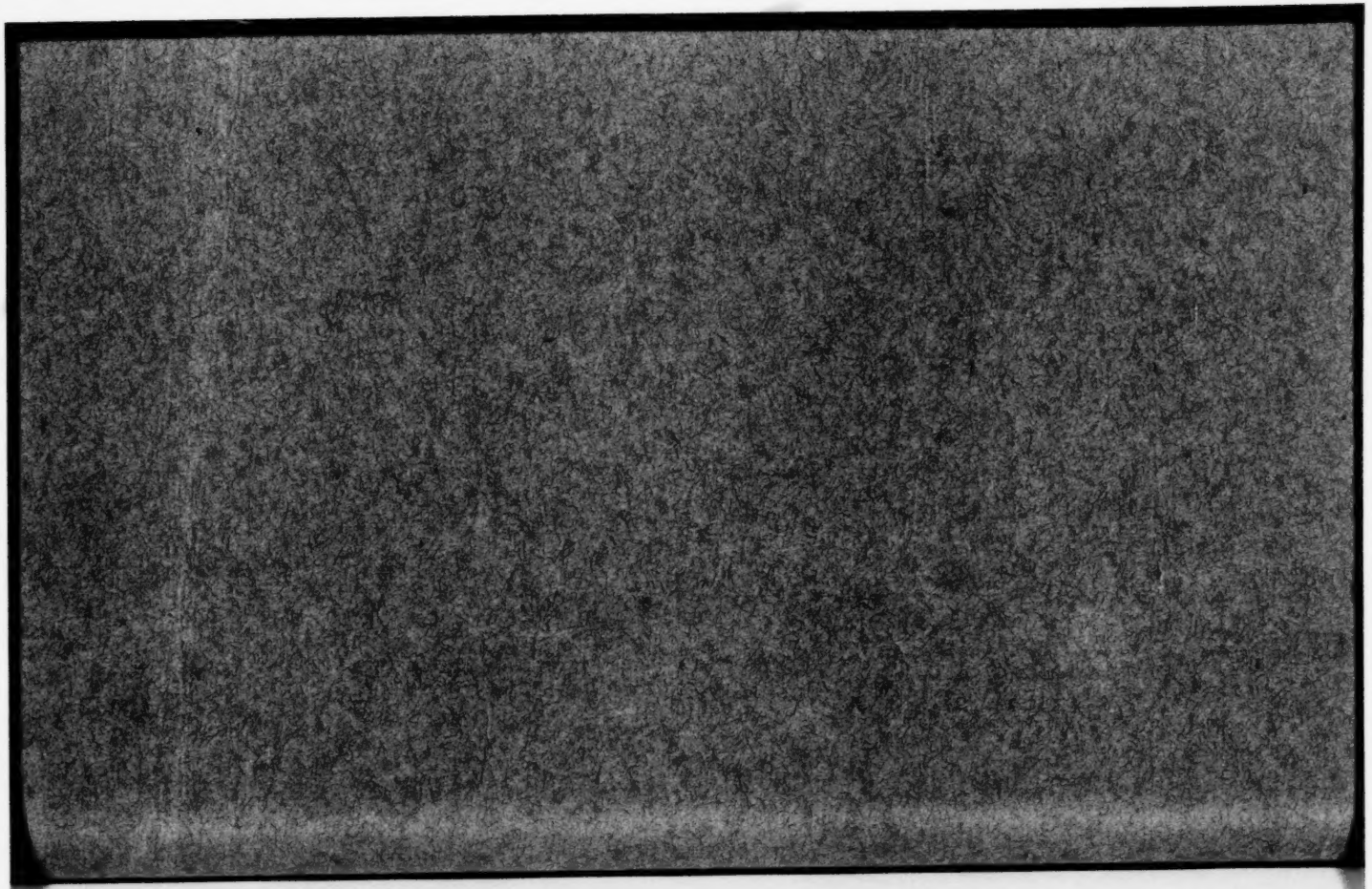
MUTUAL FIRE INSURANCE COMPANY OF GERMANTOWN, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION



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OPINIONS BELOW

The opinion of the District Court (R. 104–129) is reported in 50 F. Supp. 665. The opinion of the Circuit Court of Appeals (R. 160–168) is reported in 142 F. 2d 344.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on April 28, 1944 (R. 169). The petition for a writ of certiorari was filed on July 27, 1944. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether petitioner failed to qualify for exemption from income tax for 1938 because it was not a mutual fire insurance company whose income was used or held for the purpose of paying losses or expenses within the meaning of Section 101 (11) of the Revenue Act of 1938.

2. If petitioner was not exempt, whether it should have been allowed, under Section 207 (c) (3) of the Revenue Act of 1938, to deduct the premiums earned during the taxable year.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations are set forth in the Appendix, *infra*, pp. 12–16.

STATEMENT

Petitioner, hereinafter referred to as taxpayer, is a Pennsylvania corporation, chartered in 1843 as a mutual fire insurance company (R. 105–106) and doing business in the Counties of Philadelphia, Montgomery and Bucks (R. 114). Effective June 8, 1938, taxpayer's charter was amended, the amended charter providing that the company's business was to be conducted on the mutual plan or principle (R. 110–111). However, the taxpayer continued to conduct its business after June 8, 1938, in the same manner as theretofore, the sole change being that a different kind of insurance was written as a supplement to its fire insurance contracts, covering losses from windstorm, cyclone, tornado, hail, etc. (R. 111).

The taxpayer issued cash perpetual policies, note premium perpetual policies, and term insurance policies, at rates promulgated by the Insurance Underwriters Association for stock fire insurance companies operating in the Philadelphia area. The policies issued during 1938 had the word "non-assessable" either printed or stamped thereon. Since June 8, 1938, the taxpayer has also issued extended coverage contracts covering losses by windstorm, cyclone, tornado, hail, etc. (R. 111.)

Due to lapses of policies and to the issuance of new insurance contracts, the taxpayer's membership changed from year to year. Under the charter and by-laws, members who dropped out of the company lost all claim to or interest in accumulated surplus of the corporation. (R. 111.)

The taxpayer issued no capital stock, its net worth as shown in its annual statements being reflected in a contingent fund which on December 31, 1938, amounted to $3,186,656.37. The annual increases in the company's surplus resulting from earnings were carried to this contingent fund. The amount of the general reserve required under the Pennsylvania law during the year 1938 was $250,000. This reserve was included in the contingent fund of $3,186,656.37. (R. 111.)

Aside from the fact that the policy holders were entitled to elect the management of the taxpayer corporation, taxpayer conducted its business in a manner comparable to stock fire insur-

ance companies, charged the same rates, and paid the same brokers' commissions (R. 111–112). Of approximately 17,000 members, only two to three hundred actually attended the taxpayer's annual meetings. Like the stock fire insurance companies, the taxpayer belonged to the Middle Department of fire insurance underwriters, which fixed standard rates for its members. Mutual companies which issued policies at reduced rates or gave rebates were not admitted to membership in this organization. (R. 112.)

The taxpayer has at no time made any assessments against or distributions to its policyholders by way of dividends or otherwise, except that during the year 1873 scrip, payable in insurance, was issued to policyholders in the amount of $36,377.43 (R. 109).

Although the taxpayer was engaged in the business of insuring against losses by fire, the greater part of its income during the period beginning January 1, 1934, and ending December 31, 1938, was from investments, consisting principally of interest and rentals. For 1938, the investment gross income as computed by its accountant amounted to $155,300.81, or 71 per cent, and the underwriting gross income, including investment income in the amount of five per cent of perpetual insurance deposits (included under the regulations of the Pennsylvania Insurance Commissioner), amounted to only $62,661.53, or 29 per cent.

(R. 110.) In 1938, the taxpayer's insurance underwriting resulted in a loss of $11,436.48, and its net income from investments was $80,435.46 (R. 79, 85, 167).

The taxpayer filed its income tax return for 1938, reporting net taxable income of $25,884.52 upon which it paid a tax of $4,040.78. In the return, it reported premiums earned as $51,101.39, and the sum of $28,840.78 (representing $^{206}/_{365}$ths of the total premiums earned during the year, there being 206 days from June 8, 1938, to the end of the year) was deducted, this amount having been allegedly retained for the payment of losses and expenses. (R. 107.)

The Commissioner of Internal Revenue, upon audit of the return, disallowed the deduction claimed in the sum of $28,840.78 and assessed a deficiency tax which was duly paid. The Commissioner held that the taxpayer was mutual in form only and that the amendments to its charter in connection with its acceptance of the Pennsylvania Insurance Code were not sufficient to bring the company under Section 207 (c) (3) of the Revenue Act of 1938 (Appendix, *infra,* pp. 12–13) since no change was effected in its operations (R. 107–108). After claims for refund had been filed and rejected (R. 108–109), taxpayer filed a suit on April 29, 1942, urging (1) that it was exempt from income tax under Section 101 (11) of the Revenue Act of 1938 (Appendix, *infra,* p. 12);

(2) if not, that it was entitled to deduct all, under Section 207 (c) (3) of the Revenue Act of 1938 (Appendix, *infra,* pp. 12–13), of the premiums earned during the year amounting to $51,101.28, or that it was entitled under that Section to deduct $28,840.28, the premiums estimated to have been earned after June 8, 1938, when taxpayer's charter was amended (R. 2–7, 110–111).[1]

The District Court held, contrary to the Government's contention, that the taxpayer was entitled to classification as an insurance company despite the fact that only 29% of its income was from insurance as compared with 71% from investments (R. 115–116, 128). It held, however, that the corporation had not proved its right to exemption in that it had not shown that it operated during 1938 as a purely mutual company within the meaning of the federal statute (R. 128). It also held that the taxpayer had not established its right to any deduction under Section 207 (c) (3) of the Revenue Act of 1938. This latter conclusion was predicated upon the court's finding that the evidence failed to establish that any part of the premiums earned during the year was retained solely for the payment of losses, expenses and reinsurance reserves. The court found further that the losses and expenses of the taxpayer's insurance business in 1938 exceeded its underwriting income and that all of

[1] The amount now claimed is the larger sum (Pet. 28, fn. 6).

these losses and expenses were deducted in the company's returns (R. 112).

ARGUMENT

1. Article 101 (11)–1 of Treasury Regulations 101, construing Section 101 (11) of the Revenue Act of 1938 (Appendix, *infra*, p. 12), limits the application of the statute to companies whose business is purely mutual and whose income is used or held solely for the purpose of paying losses or expenses (see Appendix, *infra*, p. 13). The evidence here shows that for 100 years the taxpayer has, with the exception of 1873, followed the policy of retaining and accumulating its earnings instead of distributing them to the policyholders, resulting in the accumulation of a "Contingent Fund", or surplus, of $3,186,656.37. Under Pennsylvania law a reserve of $250,000 would have sufficed. Accordingly, the District Court found that the taxpayer's surplus was patently far in excess of the amount required to meet probable losses. Moreover, the premiums charged were based upon the standard rates fixed by the Insurance Underwriters Association for stock fire insurance operating in the Philadelphia area. It is significant that mutual companies which issued policies at reduced rates or gave rebates were not admitted to membership in the association of fire insurance underwriters to which the taxpayer belonged (see Statement, *supra*, p. 4). The District Court further found

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that the evidence failed to establish that any part of the premiums in controversy was retained solely for the purpose of paying losses, expenses or reinsurance reserves. Thus, the company failed to meet the requirement of the federal exemption provision (sec. 101 (11) of the Revenue Act of 1938) that its income must have been used or held for the purpose of paying losses or expenses.

It is true that a provision of the Pennsylvania law (Purdon's Pennsylvania Statutes (1930), Title 40, c. 2, Sec. 677, Appendix, *infra*, pp. 15–16), applicable to certain mutual insurance companies provided that the surplus of such corporations should be held as a reserve for the payment of losses and expenses. Assuming that this statute is applicable to the instant taxpayer, nevertheless the courts below properly held that the surplus here was not accumulated for the purpose stated, but for expansion. Plainly, the annual income from investments and earned premiums was alone far in excess of the amount needed currently to meet all claims and expenses (see R. 122, 167).[2] Since the exemption claimed depends upon the

[2] For example, in 1938 the net income from investments was $80,435.46, and the loss on insurance underwriting was $11,436.48 (see Statement, supra, p. 5). $68,998.98, the difference in these figures, is taxpayer's actual net income. The 1938 taxable net income, after the payment of claims and expenses, was $54,725.30 (which is the sum of $25,884.52, the reported net income (R. 36), and $28,840.78, the disallowed premium deductions (R. 22)).

proper classification of the taxpayer under the federal statute, the question is one of federal law and the facts are controlling, not the varying provisions of local law. *Morgan* v. *Commissioner*, 309 U. S. 78; *United States* v. *Pelzer*, 312 U. S. 399.[3]

Taxpayer urges (Pet. 11, 22–26) that the instant decision is in conflict with the following decisions of other circuits and earlier decisions of the same court: *Commissioner* v. *National Grange Mut. L. Co.*, 80 F. 2d 316 (C. C. A. 1st); *Ohio Farmers Indemnity Co.* v. *Commissioner*, 108 F. 2d 665 (C. C. A. 6th); *MacLaughlin* v. *Philadelphia Contributionship, etc.*, 73 F. 2d 582 (C. C. A. 3rd), certiorari denied, 294 U. S. 718; *Driscoll* v. *Washington County Fire Ins. Co.*, 110 F. 2d 485 (C. C. A. 3rd), certiorari denied, 311 U. S. 658.

In the *National Grange Mut. L. Co.* case, the question discussed by the First Circuit was whether certain guaranty fund units were in effect preferred stock, thereby depriving the company of the right of classification as a mutual company as distinguished from a stock company. The court held merely that the units in question constituted indebtedness. In the *Ohio Farmers Indemnity Co.* case, the Sixth Circuit held that a mutual insurance company did not lose its right

[3] Because 71% of taxpayer's income was from investments and only 29% from insurance, the Government contended below that the taxpayer was not entitled to classification as an insurance company under federal revenue laws. Cf. *Bowers* v. *Lawyers Mortgage Co.*, 285 U. S. 182. The court below found it unnecessary to consider this point (R. 168).

to such classification and become a stock company merely because it issued non-assessable policies for cash premiums paid in advance. We find nothing in either opinion contrary to the holding below that the furnishing of insurance at cost is one of the characterstics of mutual companies. In fact, the Sixth Circuit observed that one of the features of mutual companies was the right of members to participate alike in the profits and losses (108 F. 2d 665, 667), and the First Circuit pointed out that it was the purpose of the company to furnish insurance at cost (80 F. 2d at 320). The asserted inconsistency between the decision below of the Third Circuit and its own earlier decisions is of course not a proper basis for certiorari. Furthermore, the court below found that those decisions support the instant ruling (R. 163, 164).

2. If the taxpayer was not a mutual insurance company, it follows that it does not qualify for the deduction allowed solely to such companies under Section 207 (c) (3) of the statute (Appendix, *infra*, pp. 12–13). Moreover, both courts below agreed that the deduction should be disallowed on the independent ground that credit had already been taken for a like amount as losses and expenses paid during the year (R. 168).

CONCLUSION

Since there is no conflict of decisions and no other sufficient basis for review is presented, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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AUGUST 1944.

APPENDIX

Revenue Act of 1938, c. 289, 52 Stat. 447:

SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS.

The following organizations shall be exempt from taxation under this title—

* * * * *

(11) Farmers' or other mutual hail, cyclone, casualty, or fire insurance companies or associations (including interinsurers and reciprocal underwriters) the income of which is used or held for the purpose of paying losses or expenses;

* * * * *

SEC. 207. MUTUAL INSURANCE COMPANIES OTHER THAN LIFE.

* * * * *

(c) *Deductions.*—In addition to the deductions allowed to corporations by section 23 the following deductions to insurance companies shall also be allowed, unless otherwise allowed—

* * * * *

(3) *Mutual insurance companies other than life and marine.*—In the case of mutual insurance companies (including interinsurers and reciprocal underwriters, but not including mutual life or mutual marine insurance companies) requiring their members to make premium deposits to provide for losses and expenses, the amount of premium deposits returned to their policyholders and the amount of premium de-

posits retained for the payment of losses, expenses, and reinsurance reserves.

Treasury Regulations 101, promulgated under the Revenue Act of 1938:

> ART. 101 (11)–1. *Farmers' or other mutual hail, cyclone, casualty, or fire insurance companies or associations.*—To be exempt under section 101 (11) the business of the organization must be purely mutual and its income must be used or held solely for the purpose of paying losses or expenses. Neither the extent of the territory in which the company may properly operate nor the fact that it accepts premium deposits instead of assessments is decisive as to its exemption. The writing of non-mutual insurance regardless of amount will deprive a company of the exemption.
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> * * * * *
>
> ART. 207–6. *Special deductions allowed mutual insurance companies (other than life or marine).*—Mutual insurance companies (including interinsurers and reciprocal underwriters, but not including mutual life and mutual marine insurance companies), which require their members to make premium deposits to provide for losses and expenses, are allowed to deduct from gross income the aggregate amount of premium deposits returned to their policyholders or retained for the payment of losses, expenses, and reinsurance reserves. In determining the amount of premium deposits retained by a mutual fire or mutual casualty insurance company for the payment of losses, expenses, and reinsurance reserves, it will be presumed that losses and expenses have been paid out of earnings

and profits other than premiums to the extent of such earnings and profits. If, however, any portion of such amount is applied during the taxable year to the payment of losses, expenses, or reinsurance reserves, for which a separate allowance is taken, then such portion is not deductible; and if any portion of such amount for which an allowance is taken is subsequently applied to the payment of expenses, losses, or reinsurance reserves, then such payment cannot be separately deducted. The amount of premium deposits retained for the payment of expenses and losses, and the amount of such expenses and losses, may not both be deducted. A company which invests part of the premium deposits so retained by it in interest-bearing securities may nevertheless deduct such part, but not the interest received on such securities. A mutual fire insurance company which has a guaranty capital is taxed like other mutual fire insurance companies. A stock fire insurance company, operated on the mutual plan to the extent of paying dividends to certain classes of policyholders, may make a return on the same basis as a mutual fire insurance company with respect to its business conducted on the mutual plan.

Purdon's Pennsylvania Statutes (1930), Title 40, c. 2:

SEC. 675. *Cash premium policies without contingent liability for assessment.* Any domestic mutual fire insurance company, organized prior to May first, one thousand eight hundred and seventy-six, having a surplus not less than the minimum capital required for the organization of a domestic stock fire insurance company and an un-

earned premium reserve computed upon the same basis as that required of domestic stock fire insurance companies, may issue policies for a cash premium without any contingent liability for assessment.

SEC. 676. *Cash premiums instead of cash deposits.* Any domestic mutual fire insurance company, incorporated by a special act of the Legislature prior to May first, one thousand eight hundred and seventy-six, and having a surplus and unearned premium reserve as required in section one, and whose charter provides for a premium deposit which shall remain as a pledge for the performance of the depositor's covenants, which deposit, under the provision of such charter, shall be returned to the depositor at the expiration of the policy, together with a proportional dividend of the profits after deducting losses and incidental charges, and whose charter further provides that the net profit, arising by interest or otherwise, shall be ascertained yearly to every member in proportion to his, her, or their deposit for which each member shall have credit on the company's books, payable at the cancellation of the policy, may, instead of collecting such deposit money as above provided under such charter, charge a cash premium in advance, on which no dividend or return shall be due or accrue, other than return premiums on cancelled policies.

SEC. 677. *Surplus held as reserve; disposition on dissolution.* The surplus of any domestic mutual fire insurance companies issuing policies in accordance with the provisions of section one or two of this act shall be held as a reserve for the payment of losses and expenses; and, in the

event of dissolution of the company, shall be divided pro rata among the policyholders whose policies are in force at the time of dissolution, but no policyholder, other than loss claimants, shall receive more than the amount of the unearned cash premium last paid to the company for the current term of such policy. Any balance remaining shall escheat to the Commonwealth of Pennsylvania.

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